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No. 921

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1956

Commissioner of Internal Revenue,

Petitioner

vs.

Wm. Fleming and Bessie M. Fleming (Husband and Wife), F. Howard Walsh and Mary D. Walsh (Husband and Wife), and Mary D. Fleming Walsh,

Respondents.

BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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COMMERCIAL RECORDER, FORT WORTH, TEXAS—5-14-57—60

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Opinions Below

The opinion of the Court of Appeals is reported at 241 F. 2d 79. The opinion of the Tax Court is reported at 24 T. C. 818.

Jurisdiction

The judgment of the Court of Appeals was entered on February 1, 1957. Petitioner invoked the jurisdiction of this Court under 28 U.S.C., Section 1254.

Questions Presented

Should this Court entertain a petition for certiorari to review a holding of a Court of Appeals which was not dispositive of the case sought to be reviewed?

The question presented by the dispositive holding is whether the exchanges of limited overriding royalty, or oil payment, interests in producing oil properties for ranching lands and urban business property were exchanges of properties of "a like kind" within the meaning of *Section 112(b)1)* of the Revenue Act of 1939, as the Court of Appeals held.

The non-dispositive question is whether, if gain from such an exchange is to be recognized for income tax purposes, it is to be taxed as capital gain under *Section 117* of the Internal Revenue Code of 1939.

Statute and Regulations Involved

The pertinent provisions of the Internal Revenue Code of 1939 (Sections 112(b)(1), 117(a)(1) and (4) and (j)(1)(2) and of Treasury Regulations 111 (Sec. 29.112(b)(1)-1) are set forth in the Appendix hereto, pp. 13 to 18.

Statement

Fleming and associates exchanged limited overriding royalty, or oil payment, interests carved out of producing oil and gas properties for a ranch. They had held the oil and gas properties for productive use in their business of producing oil and gas; they acquired and held the ranch for investment. The market value of the ranch when so acquired exceeded the tax bases of the overriding royalties in the hands of Fleming and associates. Fleming and associates reported no taxable gain from the exchange (R. 86-92).

The Commissioner of Internal Revenue determined that the exchange produced ordinary income subject to depletion. The taxpayers involved appealed to The Tax Court of the United States assigning this action as error and taking the position that no gain from the exchange should be recognized for tax purposes because the properties were of like kind within *Section 112(b)(1)* of the 1939 Code. Alternatively, they sought a holding that, if any gain was to be recognized, it should be taxed as capital gain under *Section 117* of said Code. (R. 5-6, 26, 27, 46, 47). The Tax Court held that *Section 112(b)(1)* of said Code was not applicable but that the gain was to be taxed as capital gain (R. 83).

On cross-appeals to the United States Court of Appeals for the Fifth Circuit, the Court held that the exchange was of properties of a like kind within the meaning of said *Section 112(b)(1)* so that no gain

was to be recognized for income tax purposes. (Page 91, Appendix, Petition for Certiorari). After so holding, the Court said:

> "If we assume that we are in error in this view, and we, therefore, reach * * * (the capital gain issue) * * * raised on the commissioner's appeal * * * we find ourselves in agreement with the tax court, and, for the reasons set out in *Scofield v. O'Connor* and *Lake v. Commissioner*, this day decided, we affirm its judgment on this issue." (Page 98, Appendix, Petition for Certiorari).

The overriding royalty interests given in exchange for the ranch were evidenced by four assignments (R. 86 to 91). They were similar except for amounts and properties. One classified by the Court below as typical was thus analyzed and summarized in its opinion. (See footnote 3, pp. 92-94, Appendix, Petition for Certiorari).

> "The assignment from Fleming Oil Co. is typical and only its pertinent terms will be set out. It involved four ordinary commercial oil and gas leaseholds in which Fleming Oil Company was then the owner of an undivided one-half interest; and recited that for a valuable consideration Fleming Oil Company conveyed to Mrs. Cline:
>
> > 'The following described real property, to wit, an overriding royalty or mineral interest carved out of the interest owned by Fleming Oil Company in each and all of the oil and gas leases above described, amounting to an un-

> divided 48 128 interest in and to all of the oil in, under and that may be produced, saved and marketed from the above described tracts of land under the terms of the oil and gas leases covering the same, until the grantee above named shall have received therefrom oil of the net value of $147,000, plus an amount equal to 5% interest per annum from May 19, 1948, on the portions of the said $147,000 which may be unsatisfied from time to time.'

The instrument further provided that no interest in gas, casinghead gas or in the personal property then on or thereafter placed upon the property was conveyed; that grantee was to be entitled to receive the amount specified from the fractional part of the oil conveyed in addition to such gross production or severance taxes as might be imposed thereupon; that the conveyance was effective June 1, 1948; that all development and operating costs and expenses were to be borne by Fleming Oil Company; and that, when the grantee had received oil of the net value specified, her interest was to terminate. The instrument also provided:

> 'The execution of this conveyance shall not impose upon grantor any obligation with respect to developing or operating the property covered hereby, nor shall it be implied herefrom the grantor is in anywise obligated to see that grantee receives oil aggregating the net value of $147,000, plus an amount equal to 5% as above provided, or any lesser sum; but grantor does covenant and agree that

> grantee shall have the same but no greater right to require the grantor to develop and operate said property, in accordance with the terms of the original lease upon said property, as the original lessors therein, their heirs or assigns, might have or exercise.' "

The time of the "pay-out" or probable duration of the assigned overriding royalties, estimated from data in the record showing sums made available up to the close of the year 1952 was 5-2 3rds years as to one, 7 to 8 years as to two and 10 to 12 years as to the fourth (R. 88, 89, 90, 91, and footnote page 94, Appendix, Petition for Certiorari).

There is also involved a transaction between taxpayer Walsh and one Cross similar in all respects to the one just summarized, except that Walsh received in the exchange urban business property and the estimated pay-out of the overriding royalty which he assigned therefor was 3-1 2 years. It was treated as was the transaction of Fleming and associates by Walsh, by the Tax Court and by the Court of Appeals. (Footnote page 94, Appendix, Petition for Certiorari).

Reasons For Refusing The Writ

1.

The capital gain issue is the only issue in the other four "entirely separate proceedings" (p. 1 Petition for Certiorari) which were joined by the Commissioner

of Internal Revenue with this case in a single Petition for Writs of Certiorari.[1] Capital gain is, at most, only a secondary issue in this case. The dispositive issue in this case is whether what was stipulated to be "an exchange" consummated "in accordance with a pre-existing agreement so to do" (R. 112-118)[2] was an exchange of properties "of like kind" within the meaning of Section 112(b)(1) of the Internal Revenue Code of 1939. Only if it is held that the exchanged properties were not "of like kind" will it be appropriate or necessary to determine if the exchange produced gain taxable as long-term capital gain. The Petition for Certiorari makes only the briefest reference to this "non-taxable exchange" issue. At page 3 of the petition, after stating that the capital gain question is the "general question" the "non-taxable exchange" question is stated and classified as an "additional related question." In footnote 11, page 16, the petition further states:

> "The *Fleming* case below (Appendix B, infra, pp. 91-98) also involves another question which is intimately connected with the principal issue. In Fleming, the taxpayers received a fee simple interest in real estate in exchange for an oil pay-

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[1] *Commissioner v. P. G. Lake, Inc.*, 24 T.C. 1016, aff'd. 241 F. 2d 71, *Scofield v. O'Connor*, 143 F. Sup. 240, aff'd. 241 F. 2d 65; *Commissioner v. Weed* (T C M) 241 F. 2d 69; *Commissioner v. Wrather* (T C M) 241 F. 2d 84.

[2] It was also stipulated that the other requisites to the application of Section 112(b)(1),—that the properties exchanged be held for productive use in trade or business or for investment—were present (R. 113, 118).

ment right. Reversing the Tax Court, the Court of Appeals (Judge Borah dissenting) held that this was a non-taxable exchange of 'property' of like kind under Code Section 112(b)(1), (Appendix B, infra, pp. 94-98). The Court went further and stated that, if it was wrong in this conclusion, the gain was taxable as capital gain (Appendix B infra, p. 98)."

The petition nowhere asserts that the holding of the Court below on the applicability of *Section 112(b)(1)* of the 1939 Code conflicts with any holding of this Court or of any other Appellate Court, or that the question is important, or that the issue was wrongly decided, or otherwise presents a situation coming within *Rule 19.1(b)* of this Court. In fact, there is no conflict, the question is not important and the situation does not come within any of the provisions of said rule. If support other than the opinion below is needed for the assertion that the issue was correctly decided there, it can be found in the Treasury Regulation (Appendix, infra p. 17) ruling that the question of likeness is to be determined by the nature or character of the property and not by its grade or quality, and the Commissioner's own rulings that oil and gas leaseholds and other mineral interests are like in kind to fee lands. (*I. T. 4093, 1952-2 C.B.*, p. 130), and that perpetual water rights are like in kind to fee lands (Revenue Ruling 55-749, 1955-2 C.B., p. 295), so that the specified properties may be exchanged without recognition of gain or loss.

The substance of the provisions of *Section 112(b)(1)* of the Code has been contained in all Revenue Acts since that of 1924,[3] and has been carried forward as *Section 1031* of the Internal Revenue Code of 1954. In this period of approximately 33 years, only three cases (including this case) involving the application of the statutory provisions to exchanges of oil properties of any kind have reached an Appellate Court. All were decided by the United States Court of Appeals for the Fifth Circuit in favor of the applicability of the Section. The other two are:

1. *Commissioner v. Crichton*, 112 F. 2d 181, decided in 1941, involving the exchange of mineral interests for a hotel property.

2. *Fleming v. Campbell*, 205 F. 2d 549, decided in 1953, involving the exchange of a limited overriding royalty or oil payment out of an oil and gas leasehold for a perpetual mineral or royalty interest.

The amounts involved in all of these proceedings combined is minuscule compared with the amounts involved in most tax questions.[4]

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[3] Sec. 203(b)(1) Rev. Act of 1924; Id. Rev. Act of 1926; Sec. 112(b)(1) Rev. Acts of 1928, 1932, 1934, 1936, 1938.

[4] The question has reached the Tax Court and the Board of Tax Appeals only four times, in addition to the present case:—*Midfield Oil Company*, 39 B T A 1154; *Kimbell*, 41 B T A 940; *Bandini Petroleum Co.*, 10 T C M 999; *Horsting*, 5 T C M 421.

Under *Rule 19.1-(b)* of this Court, the Petition for Certiorari should be denied.

2.

The capital gain section *(Section 117)* and the non-taxable exchange section *(Section 112(b)(1))* of the 1939 Code are not structually connected or otherwise closely related. The Court below could have held, and this Court could hold, that the disposition of the over-riding royalty interests involved in any of the other four cases covered by the Petition for Certiorari for cash or in satisfaction of a money obligation did or did not produce capital gain, and that would not answer the question of whether the real estate received by respondents in this case, in what was stipulated to be an exchange (R. 112) was like in kind to the over-riding royalty interests which they exchanged. "Likeness in kind" is the issue in this case.

Different criteria control the applications of the sections. It seems obvious that *Section 112(b)(1)* was enacted to permit, within the limitations contained therein, dispositions of property which did not produce money or obligations expressed and convertible into money without the recognition of gain so that a taxpayer making such an exchange would not be required to resort to other sources to pay the tax. The

practical and intended effect is to defer taxation until something from which the tax can be paid is realized.

While the capital gain provisions were no doubt originally designed to avoid taxing at progressive rates in the year of sale what was actually the enhancement in value of the property sold over a period of years, this has not been the case since the holding period requisite to long-term capital gain treatment has been reduced to six months. Now, particularly since the law has been expanded to limit the deductibility of both long-term and short-term capital losses, it must be recognized that the capital gain and loss provisions are designed to produce revenue by encouraging dealings in capital assets and to protect the revenue by limiting the extent to which capital losses can be used to off-set ordinary income.

Thus, if the assertion in the Commissioner's petition that a conflict exists on the capital gain question is sustained, and this case brought to this Court for review, the question can be reached in this case only if, and after, the dispositive holding that gain from the exchanges is not to be recognized (which holding is not attacked by the Commissioner) is set aside. Such action would not tend to solve the capital gain question.

In a non-taxable exchange the taxpayer takes as his tax basis in the acquired property the basis which he had in the property disposed of. *Section 113(a)(6)* 1939 Code. Thus, when the acquired property is disposed of, the gain attributable to the first property, as well as that attributable to the second, is taxed.

3.

If it could be assumed that this case is to be considered on this Petition for Certiorari as if the "nontaxable exchange" question were not involved, and as if the Court below had merely affirmed the Tax Court's holding on capital gain, then these respondents adopt, without repetition here, the reply to the Petition for Certiorari filed on behalf of P. G. Lake, Inc. which company is represented here by the same counsel who represents respondents in this proceeding.

Conclusion

For the foregoing reasons, it is respectfully submitted that the Petition for a Writ of Certiorari in this case should be denied.

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APPENDIX

Internal Revenue Code of 1939:

"SEC. 112. RECOGNITION OF GAIN OR LOSS.

" * * *

"(b) Exchanges Solely in Kind.—

"(1) Property held for productive use or investment.—No gain or loss shall be recognized if property held for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale, nor stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest) is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment."

"SEC. 117. CAPITAL GAINS AND LOSSES.

"(a) Definitions.—As used in this chapter—

"(1) *Capital Assets.*—The term 'capital assets' means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

"(A) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

"(B) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 23(1), or real property used in his trade or business;

"(C) a copyright; a literary, musical, or artistic composition; or similar property; held by—

"(i) a taxpayer whose personal efforts created such property, or

"(ii) a taxpayer in whose hands the basis of such property is determined, for the purpose of determining gain from a sale or exchange, in whole or in part by reference to the basis of such property in the hands of the person whose personal efforts created such property; or

"(D) an obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1,

1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue.

" * * * *

"(4) *Long-Term Capital Gain.*—The term 'long-term capital gain' means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing gross income:

" * * * *

"(j) Gains and Losses from Involuntary Conversion and from the Sale or Exchange of Certain Property Used in the Trade or Business.—

"(1) *Definition of Property Used in the Trade or Business.*—For the purpose of this subsection, the term 'property used in the trade or business' means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23(1), held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or (C) a copyright, a literary,

musical, or artistic composition, or similar property, held by a taxpayer described in subsection (a)(1)(C). Such term also includes timber or coal with respect to which subsection (k)(1) or (2) is applicable and unharvested crops to which paragraph (3) is applicable. Such term also includes livestock, regardless of age, held by the taxpayer for draft, breeding, or dairy purposes, and held by him for 12 months or more from the date of acquisition. Such terms does not include poultry.

"(2) *General Rule.*—If, during the taxable year, the recognized gains upon sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets. * * *".

Treasury Regulations 111:

"Sec. 29.112(b)(1)-1. *Property held for productive use in trade or business or for investment.* —As used in section 112(b)(1), the words 'like kind' have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under such section, be exchanged for property of a different kind or class. The fact that any real estate involved is improved or unimproved is not material, for such fact relates only to the grade or quality of the property and not to its kind or class. Unproductive real estate held by one other than a dealer for future use or future realization of the increment in value is held for investment and not primarily for sale.

"No gain or loss is recognized if (1) a taxpayer exchanges property held for productive use in his trade or business, together with cash, for other property of like kind for the same use, such as a truck for a new truck or a passenger automobile for a new passenger automobile to be used for a like purpose, or (2) a taxpayer who is not a dealer in real estate exchanges city real estate for a ranch or farm, or a leasehold of a fee with 30 years or more to run for real estate; or improved real estate for unimproved real estate, or (3) a taxpayer exchanges investment property and cash for investment property of a like kind.

"A transfer is not within the provisions of section 112(b)(1) if as part of the consideration the other party to the exchange assumes a liability of the taxpayer, but such transfer, if otherwise qualified, will be within the provisions of section 112 (c).

"Gain or loss is recognized if a taxpayer exchanges (1) Treasury bonds maturing October 15, 1945, for Treasury bonds maturing June 15, 1963, or (2) a real estate mortgage for bonds of the Home Owners' Loan Corporation."